DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 03-0369
Indiana Corporate Income Tax
For the Years 1996 through 2000

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ISSUE

I. **Combined Indiana Income Tax Return** – Adjusted Gross Income Tax.

Authority: IC 6-3-2-2(l); IC 6-3-2-2(m).

Taxpayer argues that the Department of Revenue erred when it required that taxpayer – along with three other related entities – submit a combined Indiana corporate income tax return reflecting the parties' income.

STATEMENT OF FACTS

There are five parties involved in the original audit and in the subsequent protest. These five companies are commonly owned.

1. Predecessor Company: This company was in the chemical and manufacturing business until 1993 when it reorganized itself into different operating companies. After the 1993 reorganization, Predecessor Company retained a separate identity and existence.

2. Successor Company: As part of the 1993 reorganization, this company was formed "to acquire and operate [Predecessor Company's] global chemicals business." Successor Company has an Indiana presence consisting of a sales office staffed by a secretary. This Indiana office takes orders from customers throughout the United States. A regional sales manager and global manager also work out of Indiana taxpayer's office. It is admitted that Successor Company has an Indiana nexus; it has an Indiana business situs, has Indiana employees, sells products to Indiana customers, and receives income from doing business within the state. In the original 1993 restructuring, ownership of the intellectual property was transferred from Predecessor Company to Successor Company.

3. Delaware Company: This company is another of Predecessor Company's offspring. At some point following the 1993 reorganization, Predecessor Company/Successor Company transferred to Delaware Company intellectual property rights – consisting of "patent rights, trade secrets, and know-how." Successor Company now pays Delaware Company royalties for the right to use the intellectual property originally owned by Predecessor Company.

4. Fiber Company: A related out-of-state company which pays additional royalties to Delaware Company for the right to use the intellectual property.

5. Compounds Company: A second related out-of-state company which also pays royalties to Delaware Company for the right to use the intellectual property.

The Department of Revenue (Department) conducted an audit review of Successor Company's tax returns and business records. The audit review examined records for the years 1996 through 2000. Following that review, the Department concluded that Successor Company, Delaware Company, Fiber Company, and Compounds Company should report their income on a "combined return" in order to "fairly reflect" the parties' Indiana income. As a result of that determination, the Successor Company owed additional income tax. Thereafter, the Department issued notices of "Proposed Assessment" for three of the five years under consideration.

Taxpayer challenged the audit's decision requiring four of these entities to file a combined Indiana tax return arguing that Successor Company "is the only entity that has nexus in Indiana." It is taxpayer's assertion that Delaware Company, Fiber Company, and Compounds Company "do not have the requisite Indiana nexus and should not be subject to the Indiana Adjusted Gross Income Tax." Taxpayer submitted a protest to that effect, and an administrative hearing was conducted during which taxpayer elaborated on this argument. Subsequently, taxpayer submitted additional information outlining the original 1993 stock distribution which led to the restructuring of the Predecessor Company and the formation of the four entities now represented within the combined return. This Letter of Findings results.

DISCUSSION

I. **Combined Indiana Income Tax Return** – Adjusted Gross Income Tax.

In 1993, Predecessor Company "spun off" ownership of its "global chemicals businesses" by means of a "restructuring program." The Predecessor Company continued in existence as a "significant investor" in the Successor Company. As part of that restructuring program, Predecessor Company assigned to Successor Company the rights to certain specified intellectual property. Delaware Company was formed as a means to effectuate the transfer of the intellectual property from Predecessor Company to Successor Company.

By 1994, Delaware Company was – by means not entirely clear – the owner of the intellectual property consisting of trademarks, patents, and "know-how." In 1994, Delaware Company and Successor Company entered into a "License Agreement" which permitted Successor Company the right to make use of the intellectual property in return for which the Successor Company promised to make royalty payments to Delaware Company based upon the Successor Company's "aggregate Net Sales Value" of licensed products manufactured and sold by Successor Company. During 1998, 1999, and 2000, Successor Company paid Delaware Company approximately 90 million dollars in royalty payments.

Delaware Company also entered into agreements with Fiber Company and Compounds Company because those two entities also paid royalties to Delaware Company.

According to the audit report, "related foreign corporations" also paid royalties to Delaware Company. In addition, Delaware Company received "a nominal amount of royalties" from "other sources."

The issue is whether the audit was justified in requiring that Successor Company file a combined return reporting not only its own income but that of Delaware Company, Fiber Company and Compounds Company.

IC 6-3-2-2(m) provides as follows:

> In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interest, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

In addition, IC 6-3-2-2(l) vests both taxpayers and the Department with authority to allocate and apportion a taxpayer's income within and among the members of a unitary group of related entities.

> If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable;
>
> > (1) separate accounting;
> >
> > (2) the exclusion of any one (1) or more of the factors;
> >
> > (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
> >
> > (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

It is apparent from the language contained with IC 6-3-2-2(l) that the standard apportionment filing method is the preferred method of representing a taxpayer's income derived from Indiana sources. The alternate methods of allocation and apportionment – including the combined reporting method – are only employed when the standard apportionment formula does not fairly reflect the taxpayer's Indiana income.

Taxpayer's collective business structure remains somewhat ill-defined; however, a number of facts can be established with some certainty. These five entities are owned by the same shareholders. Successor Company has an Indiana nexus; it has an Indiana office, employees, and sells products to Indiana customers. Successor Company paid substantial sums of money to Delaware Company for the right to use intellectual property originally owned by Predecessor Company. Fiber Company and Compounds Company also paid substantial royalties for the right to use the intellectual property.

Other aspects of taxpayer's collective business relationship are more ambiguous. It is not entirely clear how the intellectual property – transferred from Predecessor Company to Successor Company in 1993 – came to be owned by Delaware Company. It is not entirely clear why Successor Company is now paying royalties for the right to use the intellectual property which it once owned. It is totally unclear as to what use Delaware Company puts these royalty payments. Do the royalty payments simply accumulate in Delaware Company's bank account? Does Delaware Company spend these millions of dollars to "manage" the intellectual property and to accurately "account for the royalty receipts?" Taxpayer describes the function of Delaware Company as follows: "The responsibility of [Delaware Company] is to effectively manage the granting of these [property] rights and to account for the royalty receipts and ensure their accuracy." However, the Department is unable to discern why managing property rights and accounting for royalty receipts would be worth 90 million dollars in payments spread out over three-years. Neither is it entirely clear why Fiber Company and Compounds Company also pay millions of dollars in royalties to Delaware Company. The Department must conclude that the royalty/licensing agreement is primarily intended as an artifice to minimize Successor Company's state tax liability because the licensing agreement – outside the favorable tax consequences – does not seem to have economic substance or business purpose.

Given that conclusion, the audit was wholly justified in requiring that Successor Company, Delaware Company, Fiber Company and Compounds Company file a combined return in order to more accurately reflect the parties' Indiana income. The alternative proposed by taxpayer would distort the Successor Company's income because it would reflect – as putative "business expenses" – millions of dollars in royalty payments Successor Company paid to a related company. The Department does not agree with taxpayer's assertion that recognizing these royalty payments as legitimate, substantive "business expenses" would more fairly recognize the parties' Indiana income.

The plain language of the law states that "[i]f the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana . . . the department may require, in respect *to all or any part of the taxpayer's business activity* . . . the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income." IC 6-3-2-2(l) (*Emphasis added*). The requirement that these parties submit a combined return is a solution narrowly tailored to effectuate the purpose set out in IC 6-3-2-2(l).

FINDING

Taxpayer's protest is respectfully denied.

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